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RESPONSE TO THE CONSULTATION ON STRUCTURAL MEASURES FOR THE EU ETS (CARBON MARKET REPORT)

Introduction

The Commission's Carbon Market Report dated 14 November 2012 – which presents six options which are meant to enhance the functionality of EU ETS – initiates a fundamental debate about the purpose, efficiency and sustainability of EU ETS. IFIEC welcomes this debate because the current EU ETS design does not adequately reconcile climate protection and industrial growth, thus weakening manufacturing in the short term and undermining investors' confidence in the longer term. With its contribution to the consultation, IFIEC aims to strengthen the EU ETS as a driver in combating climate change effectively, not only in Europe but globally, while at the same time strengthening the EU's economic basis by enabling efficient economic activity, high-quality jobs and growth.

In section I., IFIEC comments on the proposals by the Commission. In section II., IFIEC presents a proposal how the underlying structural flaws of the EU ETS could be addressed by redesigning the system from a static to a dynamic one.

I. IFIEC has the following view on the Commission proposals

a. Proposal: Increase the EU CO_2 reduction target to -30% until 2020

The EU CO_2 reduction target should only be increased when other important global emitters commit to comparable reduction targets. The negotiations in the past have shown that ambitious unilateral commitments by the EU do not encourage other countries to follow. The international climate negotiations are planned to come to a result in 2015.

b. Proposal: Retiring a number of allowances in phase 3

Like a., this proposal addresses the symptom – the oversupply of CO_2 allowances – and not the cause of the problem. A one-off reduction of the number of allowances cannot be a sustainable solution as the number of allowances to be retired will be based on assumptions and uncertainties. Defining the "correct" number of allowances to be retired is therefore an unsolvable question. Thus, an oversupply or a shortage of allowances in the future would not be avoided – making further market interferences likely. This would undermine the trust in the EU ETS as a functioning 'market based instrument' and would therefore also damage the international credibility of EU ETS. For these reasons, IFIEC is opposed to this proposal. As this proposal is a version of proposal a., see also above.

c. Proposal: Early revision of the annual linear reduction factor

This proposal affects industrial sectors more directly than a. and b. as the revision of the linear reduction factor will not only decrease the total number of allowances but also the number of free allowances to industry. Already, free allocation does not meet companies' demand of allowances in most cases[1], so that companies need to buy additional allowances. Should the undersupply of allowances at company level be further increased this will increase the risk of carbon leakage. For these reasons, IFIEC is opposed to this proposal. As this proposal is a version of proposal a., see also above.

d. Proposal: Extension of the scope of the EU ETS to other sectors

In principle, IFIEC supports the broadening of the EU ETS to other sectors and regions of the world as a larger scheme should provide a more robust carbon market and more opportunities for low-cost abatements for compliant industries. An extension of the EU ETS scope could also eliminate existing competitive distortions between those sectors currently within and those outside the scope (e.g. railway and road traffic). For all sectors in question it must be evaluated whether the extension of the EU ETS scope is a more cost efficient alternative to the respective existing policy framework and whether it can be implemented without burdensome regulatory overlaps. The inclusion of e.g. transport would require a consistent revision of the current policy instruments, which is highly delicate because currently taxes paid to

[1] at least at stable or growing production levels, which is essential in the framework of the EU's re-industrialization strategy, because of e.g. allocation based on historical production level and benchmark of 10% best

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the state budgets are the chosen option. Such an extension of the scope must not be aimed at increasing only the demand for EUAs without adjusting the supply accordingly. This option should be explored in detail for the fourth trading period.

e. Proposal: Limit access to international credits

Access to international credits is an important element of the EU ETS and must be preserved in the future. It is the only instrument of global nature to achieve CO_2 reductions. International credits have many positive impacts:

- They introduce the needed flexibility in the scheme allowing European industries to comply also through lower cost abatement options in non-EU countries.
- They support technology transfer and partnerships between stakeholders from different countries.
- They help connecting emerging carbon markets across the world.
- They have a positive impact on international climate negotiations as the inflow of investments as a result is the most important incentive for developing countries to negotiate a global climate agreement.

Thus, CDM and JI should be strengthened rather than limited. Besides, the EU has already restricted the use of international credits significantly: On average, each company can use international credits only for about 6% of its emissions. Furthermore, CERs produced by new projects will not be accepted from 2013 unless they come from Least Developed Countries. For these reasons, IFIEC is opposed to this proposal.

f. Proposal: Discretionary price management mechanism:

Introducing price management mechanisms such as a carbon floor price or a carbon price reserve would fundamentally modify the functioning of the market-based cap and trade system. For IFIEC, the debate on such mechanisms is of secondary importance because it ignores the current weaknesses of the EU ETS design to preserve industrial competitiveness. At current carbon price levels, the carbon leakage issue is less prominent. However, when talking about price management mechanisms we need to ensure at the same time that the carbon leakage provisions are robust (s. II.). Furthermore, a tax-like system raises the question, who may determine the "correct" CO_2 price on what basis, how and how often. For these reasons, IFIEC is opposed to this proposal.

II. IFIEC wants an EU ETS that meets climate objectives while allowing efficient industrial production

Europe needs an EU ETS that achieves the desired environmental aims and at the same time preserves EU competitiveness – even if other major economies do not commit to comparable CO_2 reduction efforts. The Carbon Market Report does not consider the latter aspect. It seems that the existing provisions to prevent carbon leakage are considered to be adequate and sufficient at whatever carbon price levels. However, this is not the case. The EU ETS design has no comprehensive and stable framework to prevent carbon leakage. In fact, the allocation based on historical (rather than actual) production levels incentivizes carbon leakage and hinders carbon efficient industrial growth and investment in the European Union. So with the current EU ETS carbon leakage will become a reality at higher price levels. This is because:

- A company under EU ETS has an incentive to decrease its production levels (i.e. transfer production to a site outside of Europe) because it can sell the "freed" CO_2 allowances. The allocation is only adapted to the production level when it drops below 50% of the historical level.
- Growth of a carbon efficient company is deterred. There is a risk that the company has to buy a significant part of the needed allowances for the growth even if the production plant is better than benchmark – despite the principle of 100% free allocation for sectors at risk of carbon leakage.[2]

The static system is also the main reason for the current oversupply with CO_2 allowances because the historic basis does not take into account the economic recession we are facing since 2008. To address this structural flaw in the EU ETS design, IFIEC proposes to change the static EU ETS into a dynamic EU ETS. Such system would:

- avoid the current imbalance between supply and demand in the carbon market.
- provide a stable, long-term framework to prevent carbon leakage.

… and could thus serve as a real example internationally.

[2] There is additional allocation foreseen for capacity extensions, however, this allocation is – besides the stringent benchmark - severely restricted through the application of the Linear Reduction Factor and the rules how the additional capacity is determined. In practice, this will often result in allocation levels much below the actual capacity extension. For a production increase within the existing capacity, there is no additional allocation. These rules deter investments in Europe.

IFIEC proposal: A dynamic EU ETS [3]

1. As long as there is no global climate policy, EU industry will receive free allocation of allowances based on challenging, but realistic benchmarks. To effectively preserve competitiveness and avoid carbon leakage, the allocation must be based on actual rather than on historical production levels and must not be decreased to a level below the benchmark.
    a. Such system would avoid both over-allocation (and a carbon price fall) in times of crisis and recession – which is the current concern – and under-allocation in case of growth which would mitigate the current limitations on growth.
    b. This would also avoid the highly complex and error-prone set of allocation rules, which are currently needed to cope with differences between the historical and the actual production level.
    c. This would set optimal incentives for carbon efficiency – in contrast to the current system. While a company today is "rewarded" for decreasing CO_2 emissions through a production decrease, a company in a dynamic system would only be rewarded for real CO_2 efficiency improvements. The dynamic system is an optimal implementation of the polluter pays principle.

2. In the proposed dynamic system, the CO_2 price would be significantly higher than today and would – if the EU ETS was the only climate policy instrument – reflect the marginal cost of carbon efficiency improvements. However, we need to be aware that the increase of electricity production from renewable energies in the EU has an impact on the CO_2 price. IFIEC Europe pleas for a careful approach when mixing different climate change policy instruments. Despite counterproductive interaction, IFIEC sees the EU policy on renewable energy and the EU ETS as complementary tools as long as there is no globally linked carbon market and as long as the marginal CO_2 reduction costs of renewable energies are significantly higher than those in EU ETS. To avoid unnecessary interferences between EU ETS and energy efficiency policies leading to higher costs, the measures proposed in the Energy Efficiency Directive should not be applied to sectors covered by the EU ETS.

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IFIEC Europe represents energy intensive industrial consumers where energy is a major component of operating costs and directly affects competitiveness.

[3] For further details, please see the IFIEC Position Paper "An enhanced EU ETS", http://www.ifieceurope.org/docs/IE%20Posit%20paper%20ETS%2006%2007%2012.pdf